



## STATE BOARD OF EQUALIZATION STAFF LEGISLATIVE BILL ANALYSIS

Date Introduced	<b>2/25/99</b>	Bill No:	<b>SB 896</b>
Tax:	<b>Insurance</b>	Author:	<b>Speier</b>
Board Position:	<b>Support</b>	Related Bills:	<b>SB 956 (1997)</b>

### **BILL SUMMARY:**

This bill would transfer the insurance tax audit and return processing functions from the Department of Insurance to the Board of Equalization.

### **ANALYSIS:**

#### Current Law:

The tax on insurers is administered jointly by the Department of Insurance (DOI), which is responsible for return processing and auditing; the Board of Equalization, which issues assessments, processes petitions for redeterminations and refunds, and hears appeals; and the Office of the Controller, who is responsible for tax collections and accounting.

Under current law, an annual tax of 2.35% is imposed on the gross premiums, minus the return premiums, of insurers not transacting title insurance in this state. Certain qualified policies sold by life insurance companies, however, are only subject to a 0.5% tax.

In the case of insurers transacting title insurance, a tax of 2.35% is imposed on all income except interest and dividends, rents from real property, profits from the sale of all investments, and income from investments.

Ocean marine insurance companies pay a 5% tax based on the average annual underwriting profit during the preceding three calendar years, or under a different formula if they have transacted insurance for less than three years.

A 3% tax is imposed on the gross premiums sold by surplus line brokers, who sell premiums purchased from insurers that are not licensed in California and are not qualified to sell policies within this state.

These taxes are imposed on insurers and their property in lieu of all other state, county, and municipal taxes and licenses, including income taxes.

### **Revised Cost Estimate**

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Proposed Law:

This bill would amend numerous sections of the Insurance Code and the Revenue and Taxation Code to transfer the auditing and tax return processing duties from the DOI to the Board. In addition, the bill would appropriate, for one fiscal year, an unspecified amount from the General Fund to the Board for the purpose of funding the Board's administration of the transferred duties.

In General:

There are approximately 1,500 insurance companies licensed to do business in California. In 1997, these companies generated taxable premiums of approximately \$48 billion, which, at the current insurance tax rate of 2.35%, resulted in tax of approximately \$1.13 billion.

In addition, there are approximately 350 surplus line brokers currently registered with the DOI. Surplus line brokers sell policies that typically are not written by insurers licensed to do business in California. Often these policies cover unusual risks and carry large premiums. Cumulatively they reported approximately \$1.49 billion in gross premiums and these registered brokers paid approximately \$38 million in tax in 1997.

The Franchise Tax Board also plays a small role in collecting the gross premiums tax on policies purchased by entities (approximately 500-700 taxpayers) directly from nonadmitted insurers, those who are not licensed to sell insurance in California. This program generates about \$4-5 million per year.

Background:

An identical bill was introduced in 1997 (SB 956, Rosenthal). That bill was also sponsored by Board Member Johan Klehs and was in response to the decision of the DOI to disband their audit division when its funding was eliminated. SB 956 advanced all the way to the Assembly Revenue and Taxation Committee before being amended to address other issues. Through SB 512 (Ch. 894, Committee on Insurance), however, DOI received a \$907,595 General Fund budget augmentation necessary for them to process and audit insurance tax returns of insurers during the 1997-98 fiscal year. A review of the proposed Governor's Budget for 1999-00 indicates \$735,000 budgeted for the DOI's tax collection and audit division, which would be identical to the 1998-99 budget.

**COMMENTS:**

1. Sponsor and purpose. Board Member Johan Klehs is the sponsor of this measure. According to his office, the purpose of a shift of the insurance tax audit program from the DOI to the Board is to protect the State's revenue base and the integrity of the Insurance Tax program. The current practice by the DOI to perform only desk audits puts at risk a portion of the \$1.13 billion tax revenue generated for vital state services from these taxes earmarked for the General Fund. Though the underreporting of tax revenues by insurance companies and surplus line brokers may be unintentional, even the smallest bookkeeping error or internal fund misallocation could cost the state hundreds of thousands of tax dollars. Board Member Klehs believes that the more

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traditional tax audits performed under the tax and fee programs administered by the Board are necessary to protect a vital portion of the state's revenues.

2. The difference between a desk audit and a field audit. Based on a review of the Board's records of assessments issued for insurance tax deficiencies between July 1997 and December 1998, the DOI has only conducted desk audits of insurance companies. In general, these desk audits consist of a comparison between supporting schedules filed with the annual insurance tax returns and a secondary sources of financial information, such as annual reports and industry publications. While desk audits are necessary for discovering transposition errors on returns or errors in carrying numbers forward from supporting schedules attached to the insurance tax return, they are not an adequate substitute for a full field audit of taxpayers' books and records.

A field audit involves a much more involved review of a taxpayer's books and records. A typical audit will include a review of an insurance company's accounting methods and income sources, income distributions, sampling of source documents for posting accuracy, and reconciliation of reported amounts. In addition to discovering any underpayments or overpayments, a field audit assures taxpayers that the tax is being uniformly enforced and promotes accuracy in self-assessments through the education of taxpayers with respect to the interpretation of the laws and regulations.

3. The Board is already heavily involved in the insurance tax return processing and audit functions of the insurance tax. The Board is currently performing many tasks related to return processing and auditing. These tasks include receiving duplicate annual returns from insurers and making initial assessments; preparing deficiency assessments for underpayment of tax; reviewing and resolving insurer petitions for redetermination (insurer appeals); reviewing and resolving insurer refund claims; providing insurers with oral hearings before the elected Board Members; preparing billings and refund documents for processing by the Controller; determining and resolving insurer appeals requesting relief from penalties; and preparing legal documents for the Attorney General in court litigation brought by insurers.

This bill would simply give the Board three additional tasks: mailing tax returns to taxpayers, receiving and processing tax return payments, and conducting desk and field audits. Since the Board currently performs these tasks for 23 other tax and fee programs which include over one million tax and fee payers, this agency has all the necessary experience and expertise to readily assume these additional duties

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4. In 1996 the Department of Insurance eliminated its Tax Audit Bureau. As a result of budgetary constraints, on October 1, 1996, the DOI eliminated its Tax Audit Bureau which in the past has performed the insurance tax audits. Though the DOI had not planned to replace the Tax Audit Bureau, SB 512 (Ch. 894, Committee on Insurance), provided a \$907,595 appropriation to fund the positions the DOI had eliminated. These are the positions which are currently only conducting desk audits. The 1999-00 budget currently proposes a \$735,000 General Fund appropriation, consistent with the 1998-99 budget. It should also be noted that in 1997 the DOI supported the transfer of the insurance tax audit program to the Board.
5. The Controller's duties would remain relatively unchanged. Except for the transfer from the Controller to the Board of the processing of the quarterly prepayments by insurance companies, the Controller's duties under the insurance tax law would remain unchanged by this bill.
6. Consideration should be given to adding the Taxpayers' Bill of Rights to the insurance tax program. The Harris-Katz California Taxpayers' Bill of Rights was enacted in 1988 (Ch. 1574), effective January 1, 1989, to place certain guarantees in the California Sales and Use Tax Law to ensure that the rights, privacy, and property of California taxpayers are adequately protected during the process of the assessment and collection of taxes. Conforming taxpayer rights were added to the Board administered Special Taxes programs in 1992 by Chapter 438 but did not include the insurance tax program presumably because DOI was responsible for those audits and the Controller was responsible for collections. Consideration should be given to adding similar taxpayer rights to this bill in the event the Board is given the authority to conduct the insurance tax audits.

**COST ESTIMATE:**

The cost to administer the return processing function of the insurance tax would require an additional 7 positions and cost approximately \$240,000 for start-up expenses and \$250,000 annually each year thereafter. The Board's costs to conduct field audits are estimated to require an additional 15 positions costing approximately \$725,000 for the first year (6 months) and \$1,071,000 for the second full fiscal year and thereafter. However, these estimated costs do not consider recent salary and postage increases.

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**REVENUE ESTIMATE:**

The following table summarizes the number and amounts of deficiency assessments issued from July 1, 1994 through December 31, 1998. Beginning July 1, 1997, the DOI no longer conducted field audits and relied exclusively on desk audits for deficiency assessments.

<u>Fiscal Year</u>	<u>Amount Determined</u>				<u>Type of Audit</u>			
	<u>Tax</u>	<u>Interest</u>	<u>Penalty</u>	<u>Total</u>	<u>Field</u>	<u>Desk</u>	<u>Self</u>	<u>Total</u>
7-1-94 to 6-30-95	8,142,548	3,190,665	84	11,333,296	8	9	4	21
7-1-95 to 6-30-96	5,310,658	939,062	17,133	6,266,853	17	51	9	77
7-1-96 to 6-30-97	7,185,932	1,447,744	0	8,633,676	11	30	0	41
7-1-97 to 6-30-98	3,004,876	1,241,795	519	4,247,189(a)	0	92(a)	9	101
7-1-98 to 12-31-98(b)	<u>760,400</u>	<u>138,306</u>	<u>4,479</u>	<u>903,183</u>	<u>0</u>	<u>33</u>	<u>4</u>	<u>37</u>
	<u>24,404,414</u>	<u>6,957,572</u>	<u>22,215</u>	<u>31,384,197</u>	<u>36</u>	<u>215</u>	<u>26</u>	<u>277</u>

(a) Amount includes 74 one-time deficiency assessments proposed by the DOI and issued by the Board on 3-31-98 in the amount of \$2,240,434 to avoid an expiration of the statute of limitations. It appears most of these assessments will be reduced dramatically as taxpayers have provided evidence to reduce the amounts subject to tax.

(b) Note that this period reflects the first half of the 1998/1999 fiscal year.

Field audit numbers include 9 field audits of surplus line brokers completed in 1996-97.

Desk audits are based on office review/examination of annual premium tax returns and retaliatory tax schedules.

Self-reported assessments are based on amended tax returns, annual statements submitted or self-reported by insurance companies.

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